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C O N F I D E N T I A L SECTION 01 OF 03 ANKARA 000686

SIPDIS

TREASURY FOR INTERNATIONAL AFFAIRS - MMILLS AND CPLANTIER
NSC FOR BRYZA AND MCKIBBEN

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TAGS: EFIN TU
SUBJECT: TURKISH TREASURY WORRY ON IMF STATE OF PLAY

REF: ANKARA 606

Classified By: Deputy Chief of Mission Robert Deutsch for reasons 1.4(b
) and (d).

¶1. (C) Summary: Showing considerable frustration and concern about Turkey's relations with the IMF, Treasury Undersecretary Ibrahim Canakci explained the GOT's thinking in its recent decision to expand the investment incentives law despite the strong opposition of top IMF management. With the Prime Minister reportedly adamant on the need for the expanded investment incentive, Canakci hoped the GOT could work out a solution with the Fund with compensating measures and not jeopardize the program, but admitted this will not be easy and take time, delaying the program. Markets remain ignorant of this potentially program-derailing situation. Canakci insisted that, outside the new investment incentive issue, the delays on the prior actions are not related to differences with the IMF. End Summary.

Expansion of Investment Incentives:

¶2. (C) Canakci confirmed February 4 that the Council of Ministers had approved an amendment to the investment incentives law at its January 31 meeting (reftel). He explained that the incentives law, adopted a year ago after a compromise with the IMF, had drawn criticism from NGO's, politicians and business people. The law had allowed rebates on income tax and employers' social security premia and partial state support for electricity costs both for existing companies that increased payrolls by at least 20% or for newly-established operations that created at least 10 jobs. These incentives applied only in the 36 provinces whose per capita GDP is under $1500.

¶3. (C) The criticisms centered on the perceived unfairness that arose from this design. Existing companies felt they were put at a disadvantage. Provinces where the per capita GDP was above $1500 protested the use of this threshold given that some of these provinces' apparently higher income level did not reflect the employment situation or the overall level of development. Canakci cited the example of Elazig, in Eastern Turkey, where the value-added from a large hydropower project lifts GDP per capita above the $1500 threshold, but the province remains relatively poor and underdeveloped.

¶4. (C) Consequently, Canakci said the new amendment uses the State Planning Organization's socioeconomic index, which uses 50 indicators, including health and education as well as income data. The amendment provides that all provinces falling below the national average using this index will be eligible for incentives. By this measure, the incentives would apply to 49 provinces rather than 36. The amendment would also apply to all employees of existing companies in these provinces, not just to newly-created jobs. He said the GOT calculates the additional annual cost at between 1.2 and 1.5 billion New Turkish Lira or about 0.2-0.3% of GNP. However, he said Fund staff put the cost at 2.5 billion NTL or 0.5% of GNP.

IMF Concerns:

¶5. (C) Canakci confirmed that the IMF has insisted on compensating measures, including in a meeting in Davos between Deputy M.D. Krueger and the Prime Minister. Canakci also noted the IMF concern on a broader, theoretical level with this kind of investment incentive. (Note: The IMF never liked the law in the first place and only agreed grudgingly a year ago after obtaining substantial narrowing of the scope of the GOT's original proposal. End Note.) Canakci admitted it would have been far better to have discussed this issue during the program negotiations in November and December, but the political leadership had only raised the issue afterwards. In an earlier conversation Ozgur Demirkol, the Treasury staff-level official coordinating work on the IMF program, said that personally he sympathized with the IMF view that the GOT should stick with what it committed to. Canakci did not contradict this.

Prime Minister Adamant:

¶6. (C) Canakci also confirmed that the GOT position comes directly from Prime Mininster Erdogan, whom Canakci described as adamant that the amended law go forward. Canakci said he had never seen the PM quite so impervious to others' arguments. Recalling last year's post-IMF negotiation populist increases in the minimum wage and pension payments, Canakci said the economic team had gone out of its way this year to brief the entire cabinet in great detail on the program, in the hopes of avoiding a repeat. At the time, noone had raised this or other issues.
Prior Actions:

7.(C) Regarding the GOT's slowness to move forward on the three key prior actions required for a Letter of Intent, Canakci admitted the GOT had moved more slowly than he would have liked, but insisted there was no substantive problem. He said the reasons for the delays had to do with the difficulty of these reforms, such that they required extensive consultations with politicians and with other stakeholders. On the Social Security reform, for example there had been meetings with "social partners" which had taken some time. (In a recent meeting with the director of the Social Security Fund who is spearheading this reform, he told us that the consultations with labor unions had been delayed by the unions' protests over the merger of social security and Ministry of Health hospitals.) Canakci also noted that persistent rumors of an impending cabinet reshuffle may have delayed GOT action.

¶8. (C) Canakci insisted that, on the substance, the GOT is fully in agreement with the Fund on these prior actions. Unspecified differences between ministers on the Tax Administration reform had been resolved by the Prime Minister, and the final version is closer to what the IMF wanted. (This tracks with press reports and what Ministry of Finance contacts have been telling us: the final version keeps tax policy outside the Tax Administration.) Canakci also said the Banking Law is close to being "finalized."

Next Steps, Timing:

¶9. (C) Canakci was vague on what happens next and how long it will take. He said the Fund is proposing sending a fiscal team to evaluate the cost of the expanded incentives and to study compensatory measures. He claimed, however, that the Fund is sending mixed signals on the exact role of this mission, and that the IMF should not come with any false hopes of changing the Prime Minister's mind on the incentives law. Canakci said the Prime Minister has accepted the need for compensatory measures and is willing to cut the investment budget. Canakci said the investment budget, previously 1.6% of GNP, had been increased for 2005 to around 2.1% of GNP. But he feared a difficult negotiation with the Fund on compensatory measures, given the need for high quality measures and Fund opposition to one-off measures or reversion to too low a proportion of investment spending. He said that if the compensatory measures involved reduced spending or certain kinds of tax increases, a supplementary budget law would be required. For other tax increases only a decree is needed.

¶10. (C) Canakci confirmed that the economic team had managed to delay submission of the amendment to parliament for 2-3 days, but he doubted they could delay much further as the Prime Minister yesterday instructed his staff to go ahead. Canakci hoped that a solution could be found with the Fund. But showing his lack of maneuvering room, he hoped the Fund would accept compensating measures, and some sort of framework to avoid this kind of problem in the future (i.e. the GOT committing not to do this again....again). Canakci hoped to avoid "substantive termination of the program."

Meanwhile, the Markets Don't Know:

¶11. (C) Canakci was understandably nervous about the fact that the markets were not aware of this problem. He said that if a solution could not be found quickly, the GOT should disclose that the problem existed, even though he realized it could cause a "deterioration" in the market's very positive recent mood.

Comment:

¶12. (C) Both the normally optimistic Canakci and the IMF Resrep (reftel) are taking a more worried tone than IMF Department Head Deppler seems to have taken at the informal board meeting on February 2. The Prime Minister seems determined to take the risk of a serious problem with the program and risk a possible market problem to get his

investment incentive through. The Economic technocrats, apparently including Minister Babacan, seem to be powerless to stop him. This situation is yet another example of the Prime Minister's erratic decision-making on economic policy, and his inability or unwillingness to play by the IMF's rules in a consistent fashion.

¶13. (C) The markets have indeed been rallying in recent weeks, driven by the continuing drumbeat of positive data releases and strong foreign investor appetite, with the yield on the benchmark bond hitting new lows around 18 percent. With no leaks yet about the new IMF problem, and the markets assuming the program will happen sooner or later, news of serious danger to the program should be a significant negative. On the other hand, Turkish markets have tended to bet the IMF will always work things out with Turkey. If markets do react, the risk is of a sharp, disruptive sell-off from perceived endangerment of the IMF policy anchor, rather than from any urgent Treasury need for the IMF disbursement. Treasury has just issued a $2 billion Eurobond and has had a recent series of successful domestic issuances.

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